

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

75-4127

No. 75-4127

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

THE EDISON CLUB,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

REPLY BRIEF
OF APPELLANT

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REPLY BRIEF OF APPELLANT

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REPLY BRIEF FOR THE APPELLANT

1. Introduction

Certain of the Commissioner's arguments require a response,
and this reply brief is directed toward that end.

2. Taxpayer's Reply

2.1. Burden of Proof

The Commissioner's basic argument is that taxpayer has failed to carry its burden of proving the Commissioner's determination of deficiencies to be incorrect. (Br. 14)^{1/} To answer this argument, it would be useful to place this case in proper perspective. In this way it will be seen that the accounting perfection apparently being demanded by the Commissioner creates a standard that is too much to ask of a social and recreational club of the type involved here.

The facts indicate that until 1965 taxpayer considered itself a tax-exempt social club and was so considered by the Commissioner. Consequently, taxpayer had little need to concern itself with the technical niceties of the Federal income tax except to the extent they related to its tax-exempt status. For example, taxpayer did not have to interest itself with depreciation deductions, interest deductions, salary deductions, or whether initiation fees and assessments should have been considered contributions to capital

^{1/} "Br." references are to the Commissioner's brief. "R." references are to the separately bound record appendix. "Ex. Vol." references are to the separately bound exhibit volume.

or gross income. These matters were unimportant because whether taxpayer's gross income exceeded or was less than its deductions, taxpayer was not subject to the Federal income tax nor could it make use of carryovers or carrybacks of net operating losses.

In December 1965, the Commissioner advised taxpayer that its tax-exempt status as a social club under section 501(c)(7) was revoked. The date this notice was sent to taxpayer is very important. It is just a few months before the beginning of the first taxable year in question here.

Upon receiving the Commissioner's advice, taxpayer did not take all formal measures it could have taken to insure beyond any doubt capital-contribution status for the assessments in question here. For instance, taxpayer could have specifically noted in each letter to its members dealing with assessments that the assessments were being set aside for capital improvements. It could have set up a completely separate savings account for all capital improvements, not just the purchase account for taxpayer's premises. It could have spent time at each annual meeting describing to its members

the Federal income tax differences between assessments taken in as capital contributions and dues taken in as ordinary gross income. Taxpayer's board could have been more descriptive in its minutes in each instance it adopted the dues structures. Specifically, the board could have separately noted that the dues structures were being adopted pursuant to Article V of taxpayer's bylaws and, more specifically, that assessments were being levied pursuant to Section D of Article V. For tax advice, taxpayer could have hired one of the national accounting firms or a law firm specializing in the tax matters of nonexempt clubs. Taxpayer could have staged "consciousness-raising" sessions intended to educate its members in the principles of Federal income taxation.

In a word, taxpayer could have created a documented record which would have resulted in clear avoidance of the Commissioner's statutory notice of deficiency. Unfortunately, taxpayer did not create such a record. Indeed, it would have been unusual if taxpayer had created such a record in light of the social and recreational nature of its operations and

its perhaps incomplete realization that it had now become a taxable entity in the eyes of the Commissioner. Instead, the pre-1966 assumptions and intentions of taxpayer and its members that amounts collected as assessments were for capital improvements remained as the assumptions and intentions of taxpayer and its members into taxpayer's nonexempt years.

But, the failure to adopt various prophylactic measures does not mean that taxpayer must now be penalized by a tax assessment with respect to receipts which neither taxpayer nor its members considered gross income. There were numerous other facts present in this case which showed that taxpayer had met the proper standard for exclusion of the assessments from gross income. The most important factors are enumerated at pages 24 and 25 of taxpayer's opening brief and need not be repeated here.

The fact is that taxpayer in many instances acted informally. Over the years a pattern had become established whereby the full budget was not specifically appended to the

minutes of taxpayer's board, although a detailed budget was obviously prepared. (R. 170-171) Similarly, while the dues structures were not appended to the board's minutes, the facts show that taxpayer did issue dues structures, that it did set forth in all dues structures (except for the dues structure for 1968) separate columns for dues and assessments, that the dues structures were sent out to each of the members, and that amounts were collected in respect of these dues structures. The Commissioner seems to be requiring that the tax treatment of the assessments be contingent upon the formal incorporation of the dues structures in the board's minutes.

(Br. 16) Such incorporation is not a requirement for a finding that the assessments here were capital contributions.

In short, with respect to the question of whether the assessments were sufficiently characterized to be considered capital contributions excludable from gross income, taxpayer did "as much as would ordinarily occur to one not learned in the nice distinctions of our tax laws." Gensinger v. Commissioner, 208 F.2d 576, 583 (9th Cir. 1953). As the Commissioner himself has "often and rightly besought," the substance, rather than

the deficiency of form, of the relationship between taxpayer and its members should be the paramount consideration in the decision here. W.S. Badcock Corporation v. Commissioner, 491 F.2d 1226, 1230 (5th Cir. 1974).

It was also necessary to examine the understanding between taxpayer and its members as to what the assessments represented. Thus, did the members believe that the assessments were to be used for operating purposes? What was the accepted meaning of the term "assessment" to the members? If the members had known the assessments were to have been treated as gross income of taxpayer, would they have tolerated continued operation of taxpayer in the manner then existing?

Taxpayer attempted to elicit answers to these types of questions, but was denied the opportunity to do so by the Tax Court. This denial came in the face of the Commissioner's long-standing position, as reflected in Revenue Ruling 75-371, 1975-35 I.R.B. 7, and the Commissioner's arguments below, that intent is the key factor in determining whether receipts of membership organizations are capital

contributions or gross income. This denial also came in the face of what must be the Tax Court's own view that intent is an important factor in making this determination. The University Country Club, Inc., 64 T.C. No. 45, CCH Tax Ct. Rep., Dec. 33,277 (June 23, 1975). Taxpayer concurs that intent is a very important factor in resolving the ultimate question raised here, although taxpayer would not go so far as to say it is the only factor.

In its brief on appeal, the Commissioner seems to back away from his rather well-established position (Br. 17-18), perhaps trying to detract from the Tax Court's error in preventing introduction into the record below of relevant testimony on the question of intent. For example, the Commissioner states that the issue here turned on what taxpayer's board did, not the beliefs of a board member as to the intentions of the board. But, to the extent the board's minutes were ambiguous as to what was done or intended, the beliefs of board members would have been extremely relevant. In addition, if the board acted contrary to taxpayer's charter or bylaws, the form of such action would not

be conclusive as to the Federal income tax treatment of the action taken.

Taxpayer thus found itself in a quandary. Taxpayer understood intent to be a crucial element in determining whether the amounts in question were capital contributions or gross income. The Commissioner, certainly in the Tax Court and in his stated positions, agreed with this view of the law. In addition, the Tax Court did not specifically deny that intent was a crucial factor and, in light of the law in this area, would have been hard put to deny the importance of this factor. Yet despite the posture in which this case was placed, taxpayer was denied the opportunity to make its showing with respect to the question of intent.

2.2. The Opinion Below

The Commissioner first notes that taxpayer's opening brief raises numerous claims of error and then refrains from replying to each of taxpayer's "rather shrill" arguments. (Br. 14) Taxpayer would note that the Commissioner does not substantially attack the specific claims of error raised by taxpayer.

Accordingly, the Commissioner never attempts to refute the point that the totality of the Tax Court's opinion indicated a failure by the Tax Court to consider adequately the issue in this case.

Admittedly, perfection is an unattainable goal, and the existence of a few errors in an opinion cannot form the basis for a reversal. However, where an opinion is inaccurate and erroneous in so many respects, the very fact of the large number of errors must cast some question on the validity of the ultimate conclusions reached.

Of special importance is the Commissioner's studious avoidance of taxpayer's argument that in arriving at its decision below the Tax Court never really considered the annual meeting notices and that, in this respect, the Tax Court further found contrary to the stipulation of the parties. The Commissioner tries to explain away the importance of the annual meeting notices by noting that the headings in the notices make reference to such terms as "income" and "expenses". The Commissioner forgets that taxpayer's membership consisted of General Electric Company employees and friends, not of tax accountants and lawyers. But, more important, the Commissioner's argument ignores the fact that the Tax Court never even took into account the annual meeting notices as an item of

evidence in its consideration below. The Tax Court's complete misreading of the nature of the annual meeting notices should alone be sufficient ground for reversal in this case.

2.3. Bear Valley

The Commissioner's attack on taxpayer's reliance on the allocation theory of Bear Valley Mutual Water Company v. Riddell, 283 F. Supp. 949 (C.D. Calif. 1968), affirmed per curiam, 427 F.2d 713 (9th Cir. 1970), must fail.

First, the Bear Valley case is not distinguishable on the basis suggested by the Commissioner. (Br. 27) Here, as in Bear Valley, the dues and assessments were intended for two specific purposes, namely, to cover certain operating expenses and to make capital improvements. In the Tax Court taxpayer attempted primarily to show that there was a direct one-to-one correspondence between assessments and capital improvements, on the one hand, and dues and operating expenses, on the other hand. The Tax Court's opinion rejected taxpayer's argument that such a one-to-one correspondence, or "earmarking", existed. On that basis, it was necessary to proceed under the

Tax Court's Rule 155 as directed by the Tax Court in its opinion. (R. 206)

Taxpayer submitted its computation. (R. 209) Thereafter, the Tax Court issued its order informing the parties that "the amounts received by petitioner from its members constituted gross income in the first instance" and, in effect, concluded that the Rule 155 computation had been unnecessary in the first instance. (R. 215)

By the cryptic last-quoted phrase the Tax Court seemed to be trying to buttress its opinion, but, whatever the meaning of that phrase, the Tax Court made no reference to taxpayer's proposed allocation as constituting a new issue. Indeed, taxpayer's proposed allocation did not raise a new issue, but constituted an unavoidable link in the logical chain connecting the Tax Court's conclusion that earmarking did not exist to the ultimate conclusion as to the exact dollar amount of assessments that would be excludable from gross income.

In addition, contrary to the Commissioner's contention (Br. 25), the allocation argument under the Bear Valley case

does not raise factual issues which were not contemplated in the proceedings below. There are numerous stipulations relating to the amount of expenditures which were considered capital in nature by both parties, and the Tax Court itself made similar findings of fact. (R. 148-152, 180)

Finally, the Bear Valley approach, even if made by reference to subsequent events, is not inappropriate. In the Bear Valley case certain amounts were paid out of one pool of funds for direct services rendered by the mutual water company while other amounts were paid for capital expenditures. The Bear Valley allocation is merely a way of valuing the services element and the capital-contributions element. In other words, subsequent events may be of importance in determining whether amounts received by a corporation are paid for the purpose of acquiring capital improvements or augmenting capital structure. See United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (1973).

2.4. The Commissioner's Additional Arguments

The Commissioner makes the point that the record contains no dues structure for the taxable year 1967. (Br. 16) This is erroneous. The stipulation indicates that the dues structure for 1967 was the dues structure as presented to the Tax Court below. (R. 18; Ex. Vol. 25)

The Commissioner points out, as taxpayer admits, that the amounts collected as assessments during the years in question were not exactly equal to the amounts transferred to the special savings account. (Br. 20) This discrepancy merely reflects that taxpayer was in a state of transition from a tax-exempt club to a nonexempt club. Why the amounts credited to the 501 account did not exactly equal the amounts transferred to the special savings account may never be known, although the uncontradicted testimony of taxpayer's bookkeeper indicated that there was a direct relation between the two amounts. (R. 66-67) The nature of this discrepancy relates to relatively minor bookkeeping matters. This discrepancy should not affect the fact that, when the record is

viewed as a whole there was a sufficient segregation of amounts for the purchase of taxpayer's premises. Furthermore, even this bookkeeping discrepancy was resolved in the year immediately after the years in question as reflected by entries in taxpayer's books.

The Commissioner's reliance on West Side Tennis Club v. Commissioner, 111 F.2d 6, 9 (1940), certiorari denied, 311 U.S. 674 (1940), and the opinion of the Board of Tax Appeals in the same case, 39 B.T.A. 149, 159-60 (1939), should be read in connection with the cooperative housing corporation cases such as Eckstein v. United States, 452 F.2d 1036 (Ct. Cl. 1971), Cambridge Apartment Building Corporation, 44 B.T.A. 617 (1941), and 874 Park Avenue Corporation, 23 B.T.A. 400 (1931). The proposition to be remembered from both the West Side Tennis Club case and the cooperative housing corporation cases is that the accounting treatment rendered receipts of a corporation is a factor to be considered in determining whether the receipts should be considered capital contributions. In the instant case taxpayer submits that

the accounting factors showing that the receipts in question were in fact capital contributions far outweigh the accounting factors showing to the contrary.

By reference to the fact that taxpayer included initiation fees in gross income on its tax returns, the Commissioner implies that initiation fees were gross income. (Br. 21) As taxpayer pointed out in its opening brief, what taxpayer did on its tax returns decides no issue in this case. In filing its initial petition in this case, taxpayer met the issues raised in the Commissioner's statutory notice. That taxpayer did not go further by trying to seek a refund for overpayments of tax should not be held against it in this proceeding.

The Commissioner makes the point that not all of taxpayer's members were regular members and, hence, not all had voting rights and rights of ownership. (Br. 23, fn. 11) Even assuming that the nonregular members would not have had rights upon liquidation, which is not necessarily a question with a clear answer, the most that can be concluded from such an argument is that a further allocation would have been

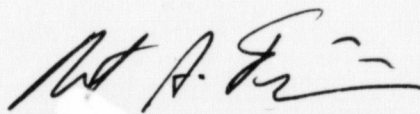
necessary to allow taxpayer to exclude from income only those assessment payments received from regular members. This is a computational problem and does not affect the resolution of the ultimate issue in this case.

Finally, the Commissioner fails to meet taxpayer's argument that the intent and belief of taxpayer's members as elicited from a witness who spoke to such members falls within a long-established exception to the hearsay rule. 6 J. Wigmore, Evidence § 1714-1731 (3rd ed. 1940).

3. Conclusion

For the foregoing reasons, and for the reasons stated in taxpayer's opening brief, the decision of the Tax Court should be reversed.

Respectfully submitted,

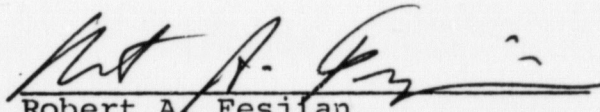


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4. CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing three copies thereof on this 24th day of November, 1975, in an envelope, with postage prepaid, properly addressed to him as follows:

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